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I. INTRODUCTION

The purpose of this document is to generally describe the bond issuance process for the Michigan Public Educational Facilities Authority (the "Authority"). This memorandum first describes the general aspects of tax-exempt bonds. It then describes the new Qualified Public Educational Bond that could be sold by the Authority.

II. GENERAL DISCUSSION OF TAX-EXEMPT BONDS

A. Tax-Exempt Status of Bonds

Interest earned on a bond or similar investment is generally taxable as ordinary income under the Internal Revenue Code. However, Section 103(a) of the Code excludes from gross income for federal income tax purposes interest on "any State or local bonds".

There are several categories of state or local governmental issuers whose bonds are tax-exempt under Section 103 of the Code. These include, among others, (i) any of the 50 states of the United states, (ii) political subdivisions of a state or local governmental unit and (iii) constituted authorities empowered to issue obligations on behalf of any state or local governmental unit. The Authority qualifies as a constituted authority specifically authorized under state law to issue bonds.

B. Governmental Bonds vs. Private Activity Bonds

In order for the interest on a state or local government bond to be tax-exempt, the proceeds of the bond generally must be used for governmental purposes. For example, the construction, renovation, and operation of public schools is an activity eligible for financing with tax-exempt bond proceeds.

If the proceeds of the bond are not used for governmental purposes, the bond will most likely be a "private activity bond". Generally, the proceeds of a private activity bond are used by a for-profit business or for personal purposes. Private activity bonds are generally not tax-exempt. If a bond is a private activity bond, it can still be tax-exempt, however, if it fits into one of several qualified bond categories. Included within this list of qualified bond categories are "exempt facility bonds" as described in Section 142(a) of the Code. Qualified public educational facility bonds are exempt facility bonds.

C. Bond Issuance Process for an Authority

Under a typical bond transaction involving a state authority, the state authority will issue bonds on behalf of the underlying borrower. The bond proceeds will then be loaned to the borrower pursuant to the terms of a loan agreement and a promissory note. The state authority uses the loan repayments to make the debt service payments on the bonds to the bond trustee, who in turns make principal and interest distributions to the bondholders. In order to provide additional security for the bonds, a municipal bond insurance policy or a letter of credit may be obtained for the bonds. A chart illustrating this bond issuance process is attached as **Exhibit A**.

III. QUALIFIED PUBLIC EDUCATIONAL FACILITIES BONDS

As described above, generally bond proceeds from tax-exempt bonds may not be used for private purposes. The Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Tax Act") amended the tax code to authorize a new type of tax-exempt bonds for elementary and secondary public school facilities which are owned by private, for-profit corporations. In order to qualify for such a characterization, the private, for-profit must have entered into an agreement with a state or local educational agency whereby the for-profit corporation agrees to construct, refurbish, equip or rehabilitate a school facility. The school facilities are then leased to the public school agency for no additional consideration.

Because these are private activity bonds, albeit qualified private activity bonds, they are subject to several restrictions and requirements. For federal tax policy reasons, only a certain dollar amount of such bonds is allowed to be issued per year. The 2001 Tax Act provides that a bond limit (also known as a volume cap) of $10 times the population of the state may be issued per year. Additionally, costs of issuance may not exceed 2% of the proceeds of the issue, the average maturity of the bonds may not exceed 120% of the average reasonably expected economic life of the facilities being financed, and a formal public hearing and approval are required before the bonds may be issued.

The Authority was created specifically to take advantage of the bond issuing capacity made available by the 2001 Tax Act. The Authority is given the responsibility to determine that its volume cap is not exceeded in any calendar year.

The steps that the Authority will need to take to authorize the issuance of qualified public educational facilities bonds are fairly straightforward. For each bond issue, the Authority Board will adopt an inducement resolution to start the process. The necessary bond authorizing documents will then be prepared and a public hearing on the issuance of the bonds will be held. The Authority Board will then meet to adopt a second resolution, which will be the bond authorizing resolution, the Authority Board will approve entering into a loan agreement with the for-profit corporation and will approve the use of an offering memorandum to market the bonds.

The bond issuance process will be similar to that used for other State authorities. A chart illustrating the flow of funds for a typical qualified public educational facility bond transaction is available as the **QPEF Flowchart**.

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If you have any questions regarding this document, please do not hesitate to contact James P. Kiefer at 517/374-9126 or jkiefer@dykema.com.